

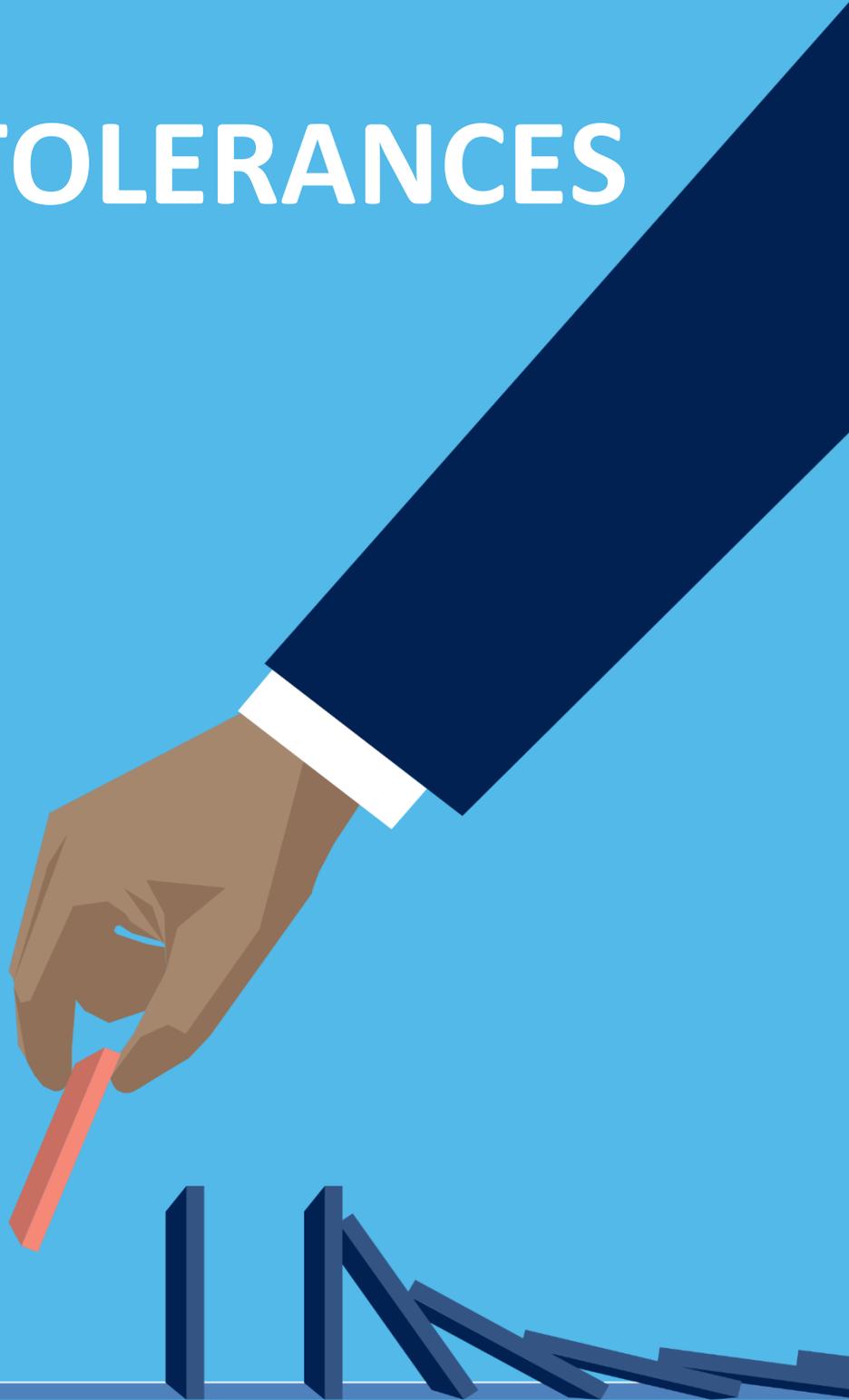
THE  
INVESTMENT  
ASSOCIATION

Operational Resilience

# IMPACT TOLERANCES

Appetite for Disruption

May 2021



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# FOREWORD



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“We would emphasise that being operationally resilient is an iterative and evolving process. As we have seen with the pandemic, disruption can happen at any time and we should assume that it will occur.” FCA, PS21/3

This report is published at a timely moment, having just heard the FCA’s confirmed expectations in their policy statement. It represents the culmination of the work of the Impact Tolerances Working Group (Working Group) convened by the IA in collaboration with PwC. It is the third in our series of operational resilience publications seeking to aid members as they look to operationalise different elements of the regulatory requirements.

The focus of this report is on guiding members through the process of setting impact tolerances; the next step after a firm has identified their important business services and a key stage in the regulator’s resilience expectations for firms.

So why should you be setting impact tolerances? The FCA clearly mandates that enhanced firms under the Senior Managers and Certification Regime (SM&CR) must set an impact tolerance for each of their important business services. However, the benefits are more wide-ranging than just compliance. Setting impact tolerances

encourages firms to build their internal understanding of their important business services and underlying dependencies. Likewise, understanding how you can remain within your tolerances can offer a competitive advantage as well as driving investment to areas which need strengthening.

Outlining how firms might set impact tolerances holds benefits for those enhanced firms in scope but this report is also intended to offer considerations to aid those SM&CR core, out of scope, firms in their own resilience work during these uncertain times. These core firms may wish to apply the principles of the regulations for their own risk management purposes. However, the extent to which firms choose to do this should be based upon a risk-based judgement on their recent business experience and future outlook.

Our members have shown crucial resilience throughout the Covid-19 pandemic and vital lessons have been learnt. It remains in everyone’s interest to build on these lessons and remain resilient against future scenarios. We continue to support members through our various engagement channels including our Operational Resilience Committee, programme of webinars and events and bilateral meetings.

Stay up to date with our dedicated expert page [theia.org/operational-resilience](https://theia.org/operational-resilience).

# PART 1 BACKGROUND

## Executive Summary

Setting impact tolerances for each of a firm's important business services is a crucial step to build and improve operational resilience.

The concept of setting impact tolerances was first introduced by the UK regulators in their Discussion Paper (DP) *Building the UK financial sector's operational resilience* in 2018. They further developed their thinking on this subject in the subsequent package of consultation papers (CPs) on operational resilience issued in December 2019. Recently, the regulators have issued a suite of policy and supervisory statements including a shared final policy summary. Of most relevance to firms is the FCA's policy statement (PS21/3) articulating their expectations for firms to set impact tolerances as part of a set of wider requirements for firms to build their operational resilience.

In light of this regulatory backdrop, the IA's Impact Tolerances Working Group, with the support of PwC, was set up last year to address the regulatory proposal for firms to set impact tolerances for each of their important business services. This report represents the insights gained from this Working Group and intends to outline the regulatory requirements as well as explore approaches regarding setting impact tolerances and writing tolerance statements.

We identify the necessary pre-requisites firms should have in place in **Section 2a**. This includes understanding your important business services, what the effects of disruption could mean for your consumer base as well as what might constitute

'intolerable harm'. A methodology is proposed in **Section 2b** of how a firm might choose to set impact tolerances, including an overview of the steps firms can take to achieve this in a proportionate manner. An exploration of taking a judgement-led or data-led approach to setting impact tolerances is also included here, and developed in the successive sections.

Additionally, in **Sections 2c** and **2d** we examine the model in more depth, supplemented by insights and examples gained from the Working Group. We also look at the related common areas of challenge firms have been facing. These include determining the appropriate level of granularity at which to define a firm's important business services. Likewise, balancing the need for a duration-based metric by which to set an impact tolerance for an important business service alongside supplementary metrics was highlighted as a common challenge.

Building on the examples laid out in the policy statement, we have included an example tolerance statement in **Section 2e** to aid firms' own judgements on how they may wish to articulate where they have set their impact tolerances and the rationale to support these decisions.

A list of questions for firms to consider as they approach the process of setting impact tolerances is included in **Section 3**. These are intended to prompt discussions and act as a starting point for firms embarking on this journey.

We hope this report will be of value to members as they look at setting their impact tolerances and determining intolerable harm thresholds.

# INTRODUCTION

This report is intended to help build an industry view of how firms can look at setting impact tolerances. It provides an approach to consider in determining impact tolerances, be that data or judgement-led.

The guidance provided within this report is, by its nature, generic, and there are decisions for firms to take in order to tailor it to their own needs and organisational structure in a proportional fashion given the relative complexity of their business and delivery mechanisms.

As a starting point, it is useful to understand why the regulators are asking firms to set impact tolerances and how these differ from the more traditional recovery time objective (RTO) or risk appetite concepts previously used in operational risk management.

## Why do firms need to set impact tolerances?

Setting impact tolerances is intended to help firms understand the point at which intolerable harm occurs to consumers or a risk is posed to the orderly operation of financial markets. As such, being able to plan for scenarios where harm could occur will help ensure that firms are able to operate within their impact tolerances. The key principle behind the thinking is that setting impact tolerances helps ensure that boards and senior management prepare for the inevitability of disruption, rather than only trying to minimise the probability of disruption. This has the benefit of ensuring consumer protection and ensuring the overall resilience of firms and the market.

It is clear that the FCA is looking for a step-change to existing risk management practices:

*Setting impact tolerances is intended to **change the mindset** of firms' boards and senior management away from traditional risk management towards accepting that disruption to business services is inevitable, and needs to be managed actively.<sup>1</sup>*

However, whilst the concept of impact tolerances may be relatively novel, to achieve the intended resilience outcome, firms can build on existing risk management structures, metrics and data as well as leverage traditional business continuity planning and other disciplines.

## How does an impact tolerance differ from a risk appetite or RTO?

It is evident the regulator<sup>2</sup> wants firms to consider impact tolerances separately from traditional approaches to operational risk management and business continuity planning. However, encouraging a mindset shift within firms to understand how an impact tolerance threshold differs from a RTO or risk appetite can be tricky to achieve in practice. A risk appetite is focussed on the likelihood of risk crystallising, whereas an impact tolerance operates under the assumption a risk will crystallise and so encourages firms to focus on improving their operational resilience. Likewise, a RTO is a time-bound metric based on how long it will take a process to get up and running, whereas an impact tolerance goes beyond this with a service-led focus on preventing harm to consumers and risk to market integrity and firm itself.

<sup>1</sup> CP19/32 *Building Operational Resilience*, 5.8. p16.

<sup>2</sup> Megan Butler in her speech ['The view from the regulator on Operational Resilience'](#) in December 2019 indicated that 'identifying your firm's maximum tolerable level of disruption to

an important business service - from a public interest perspective - should produce a threshold that is quite different to your established risk appetite and risk tolerance metrics.'

## IA activity

The IA's Working Group was formed under the Operational Resilience Committee as part of a series of working groups seeking to help members operationalise different elements of the operational resilience proposals suggested by the regulators. The Committee has been supporting members with building their operational resilience from the publication of the DP, through the consultation process and publication of the policy statement and will continue into the implementation and transitional period.

The Working Group was formed last year, with representation from over 20 member firms to address and navigate the challenges with setting impact tolerances for each of a firm's important business services. This report represents the third publication in our operational resilience series, building on the foundations of the work of the IA's Important Business Services Working Group<sup>3</sup> and Governance Working Group<sup>4</sup>. The next phase of the IA's operational resilience workplans involves convening a workstream on scenario testing, looking at how firms might identify severe but plausible scenarios and test their ability to remain within their impact tolerances.

The IA will continue to engage with regulators to represent investment management industry views through ongoing meetings and roundtable discussions, encouraging the regulators to adopt a proportionate supervisory approach.

## Regulatory landscape

### Definitions and regulatory requirements

The FCA expects firms to use impact tolerances as a planning tool and be assured that they can remain within their tolerances in severe but plausible scenarios.

The FCA defines impact tolerances as describing the

*'maximum tolerable level of disruption to an important business service, as measured by a length of time in addition to any other relevant metrics, reflecting the point at which any further disruption to the important business service could cause **intolerable harm** to any one or more of the firm's clients or pose a risk to the soundness, stability, or resilience of the UK financial system or the orderly operation of the financial markets.'*

Firms will also be required to understand and implement:

- The point at which intolerable harm occurs to consumers.
- The point at which disruption could pose a risk to market integrity and to the firm itself.
- The **appropriate metrics** to set impact tolerances, including a mandatory time-based metric specifying that an important business service should not be disrupted beyond a certain period or point in time. Firms can use a **combination** of metrics, or a single duration metric if appropriate.
- The **fluctuations in demand** for its important business service at different times of the day and throughout the year to ensure that its impact tolerance reflects these fluctuations and is appropriate in light of the peak demand for the important business service.
- The **aggregate harm when multiple business services are disrupted**, particularly where they rely on the same underlying system, when setting impact tolerances.
- The need to keep impact tolerances under review at least **annually** and if there is a material change to the firm's business or the market in which it operates.

For more detail on the full requirements for firms and the amendments to the Senior Management Arrangements, Systems and Controls sourcebook (SYSC) please see **Appendix 1**.

<sup>3</sup> IA *Operational Resilience: Important Business Services*, (June 2020).

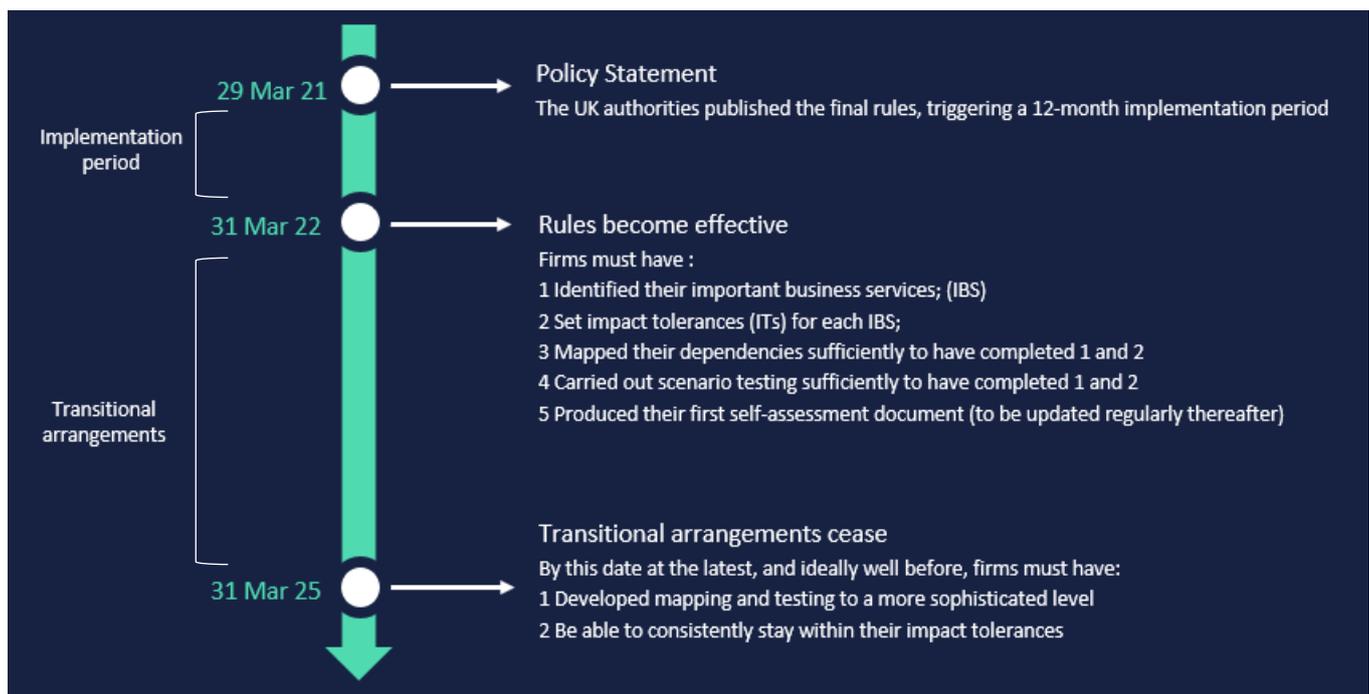
<sup>4</sup> IA *Effective Governance of Operational Resilience* (February 2021).

Dual-regulated firms (a firm that is a bank, building society or UK designated investment firm that is subject to both the PRA and FCA) will be expected to set and manage up to two impact tolerances for each of their important business services, taking into account the statutory objectives of each authority. However, **this report is mainly focused on providing considerations for solo FCA regulated firms which are required to set a single impact tolerance for each of their important business services.**

It is important to emphasise that there is no prescribed way to meet the regulatory expectations regarding setting impact tolerances, however, it remains essential to document and be able to evidence the methodology used.

## Timeline for compliance

The policy statement was published in March 2021 and indicated that an implementation period will last until 31 March 2022. By this point, firms must have identified their important business services and set impact tolerances for each important business service, and then have mapped their dependencies and carried out scenario testing to a sufficient level of sophistication. This means to a level of detail sufficient to achieve the policy outcomes of appropriately identifying important business services, setting impact tolerances and identifying vulnerabilities. The rules will be effective from 31 March 2022 and firms will then have a maximum of three further years (with a view to concluding as soon as reasonably practicable) to develop the sophistication of their mapping and scenario testing to enable them to operate consistently within their impact tolerances.



## International regulators

Since the UK regulators initiated the discussion on operational resilience, there has been growing international regulatory interest in the subject. This has been partly in light of the disruption caused by the pandemic which has evidenced the plausibility of a severe disruption affecting financial services firms. Much has been aimed at banks, but many of the regulatory principles still hold relevant considerations for investment managers as well as providing a sense of the regulatory direction of travel. Whilst it is evident that the notion of setting impact tolerances and the requirement to measure these in terms of duration is unique to the UK, other regulators are including the spirit of this concept even if they articulate it slightly differently.

- The **Basel Committee on Banking Supervision (BCBS)** issued their *Principles for Operational Resilience* in March 2021, following consultation<sup>5</sup>. The BCBS seeks to promote a principles-based approach to improving operational resilience, which is broadly aligned with the FCA's approach. However, it diverges in the respect that it expects banks to adapt their existing risk appetite and identify the bank's tolerance for disruption<sup>6</sup>. Additionally, it expects firms to apply their tolerance for disruption for their critical operations, a term which encompasses critical functions as well as the activities, processes, services and their relevant supporting assets. The BCBS encourages banks to leverage their existing operational risk management functions and business continuity planning frameworks to prepare for a range of severe but plausible scenarios. The emphasis is not so much about assuming disruption will happen but preparing for the risk that disruption might impact a bank's critical operations.
- The **European Commission's** proposed *Digital Operational Resilience Act (DORA)* was released for consultation in September 2020<sup>7</sup>. This includes a package of measures intended to drive operational resilience within financial services and with a particular focus on information and communications technology (ICT) risk management. Unlike the UK's approach, DORA considers how firms should manage risks - specifically ICT and ICT third party risks - and does not require firms to explicitly set an impact tolerance for an end user service.
- The **US Joint Authorities** (Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency) published a paper outlining *Sound Practices to Strengthen Operational Resilience* designed to help large banks strengthen their operational resilience in the face of internal and external operational risks in October 2020<sup>8</sup>. Whilst the Joint Authorities do not refer to 'impact tolerances' explicitly, they propose that a firm's risk appetite should articulate their 'tolerance for disruption' and prepare for a range of severe but plausible scenarios<sup>9</sup>.

Similar themes are present in IOSCO's<sup>10</sup> and Ireland's<sup>11</sup> work. In the UK, a level of industry good practice is developing, to supplement the regulatory approach. The **Operational Resilience Collaboration Group (ORCG)**, which is made up of industry practitioners of operational resilience, with regulators as observers, has published a paper on impact tolerances<sup>12</sup>. This IA report intends to be complementary to the principles suggested by the ORCG on setting impact tolerances and forming impact tolerance statements.

<sup>5</sup> BCBS, *Principles for Operational Resilience*, (March 2021)

<sup>6</sup> The Committee defines 'tolerance for disruption' as the level of disruption from any type of operational risk a bank is willing to accept given a range of severe but plausible scenarios.

<sup>7</sup> European Commission, *Proposal for a Regulation of the European Parliament and of the Council on digital operational resilience for the financial sector and amending Regulations (EC) No 1060/2009, (EU) No 648/2012, (EU) No 600/2014 and (EU) No 909/2014*, (September 2020)

<sup>8</sup> US Joint Authorities, *Sound Practices to Strengthen Operational Resilience*, (October 2020)

<sup>9</sup> The Joint Authorities define a tolerance for disruption as 'determined by a firm's risk appetite for weathering disruption from operational risks considering its risk profile and the capabilities of its supporting operational environment. A firm's tolerance for disruption is informed by existing regulations and guidance and by the analysis of a range of severe but plausible scenarios that would affect its critical operations and core business line.'

<sup>10</sup> IOSCO, *Outsourcing principles to ensure operational resilience* (May 2020)

<sup>11</sup> Central Bank of Ireland, *CP140 - Cross Industry Guidance on Operational Resilience* (April 2021)

<sup>12</sup> Operational Resilience Collaboration Group (ORCG), 'Impact Tolerances Industry Standard', October 2020 available via their LinkedIn Group.

# PART 2 PRACTICAL CONSIDERATIONS FOR INVESTMENT MANAGERS

This report aims to help firms establish a framework for setting impact tolerances and provide a methodology which is proportionate and best suited to their own business model, consumer base and service delivery mechanisms. For example, not all steps may be relevant for firms with a relatively simple business model or straightforward operational structure. This section of the paper is focused on offering practical considerations for investment managers when setting impact tolerances and has been aided by PwC's insights from wider financial service sectors. This includes helping firms understand the necessary pre-requisites determining the threshold for intolerable harm, as well as a series of steps firms can follow to set their impact tolerances and their related challenges. In addition, it includes an example impact tolerance statement, intended to help firms articulate their impact tolerances.

## 2a Starting point

There are a few pre-requisites firms should have considered before progressing with their impact tolerances:

- Have you identified your important business services?
- Do you have the data which reveals the day-to-day functioning or performance of the important business service?
- Have you identified the appropriate metrics to be able to set your impact tolerances? It is worth noting that the use of supplementary metrics to the requirement to measure the duration can better define the actual impact of disruption, particularly as determining the duration will often be an approximation.
- Understanding your client base is key to determining a threshold for intolerable harm. Do you understand and/or have full visibility of the clients using your services?
- Have you considered how a disruption might translate into inconvenience, harm and intolerable harm?

### Mitigating harm to the consumer and the risks posed for firm and market stability

In general, inflicting harm on consumers is likely to be the biggest concern for the investment management industry rather than causing a risk to market integrity or the wider economy. In most cases, we expect firms in the investment sector would not have the potential to affect wider financial stability or market integrity. Consumer harm is the most relevant consideration, and in any case would be the first impact to be felt.

The FCA provided some helpful clarity on how firms can determine what constitutes 'intolerable harm' in their policy statement. They indicate that intolerable harm is far more severe than inconvenience or harm and that for both 'harm' and 'inconvenience' they would expect firms to be able to remediate any disruption to prevent any ill effects to be felt in the medium-/long-term by clients/markets.

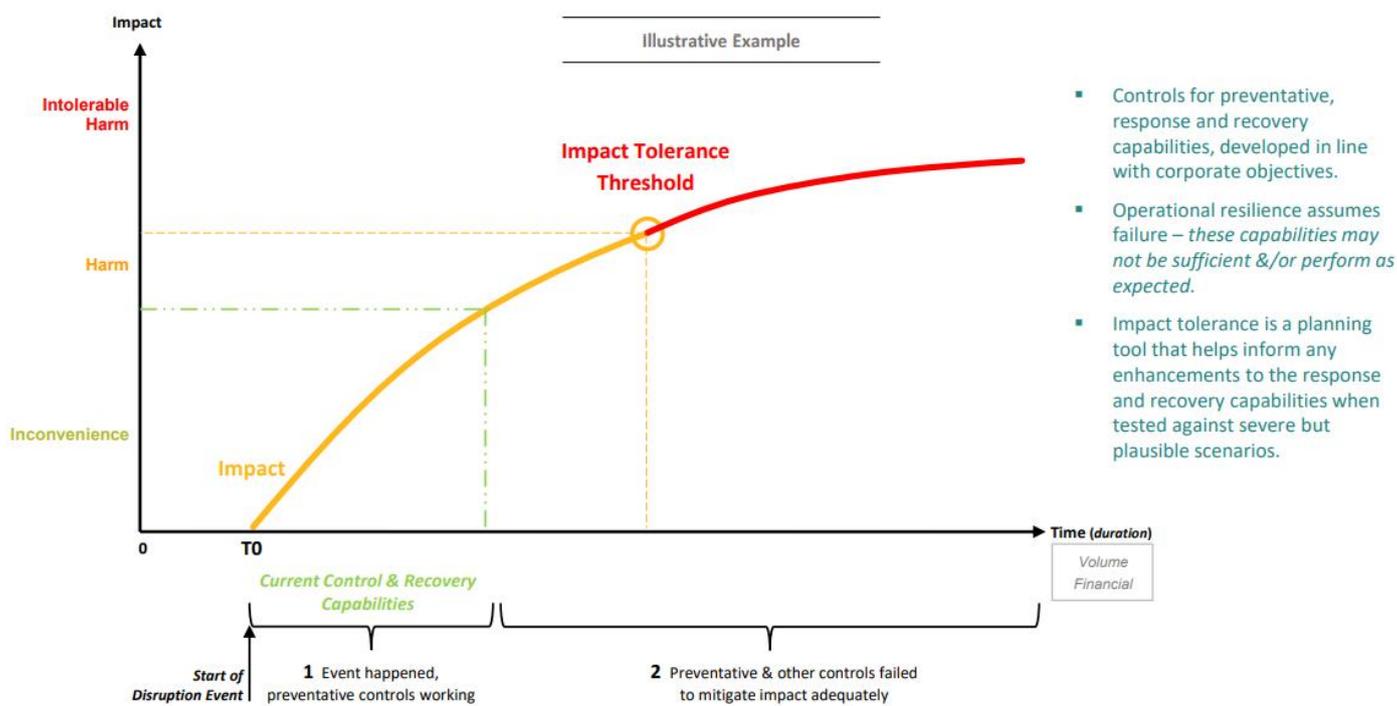
**Intolerable harm:** harm from which consumers cannot easily recover e.g. where a firm is unable to put a client back into a correct financial position, post-disruption, or where there have been serious non-financial impacts that cannot be effectively remedied.

However, establishing the point in time at which harm occurs and categorising the threshold for intolerable harm can be a challenge. The ORCG explored this issue in their principle-based guidance on impact tolerances, and the following illustration shows how firms can understand when an impact translates into intolerable harm. In particular, it is helpful to consider a spectrum of impact taking into account inconvenience, harm and intolerable harm.

When assessing the point in time where intolerable harm might manifest, the ORCG also encourages firms to base this assessment on the pretext that no resilience and recovery controls would be available. This can aid firms in determining whether their resilience and recovery controls are appropriate in preventing a breach of their impact tolerance threshold and to offer assurance.

**ORCG diagram<sup>13</sup>**

The diagram below shows how a disruption event unfolds and its associated impact on clients, markets and firm (orange and red line)



How can firms understand the effects of disruption, taking into account vulnerable customers?

Disruption does not always translate into harm, as there may be a certain level of disruption beyond what is normal which may not cause particular harm. For instance, if there was a breach of the settlement date on a payment, intolerable harm may not be inflicted on every consumer affected in that scenario, as amongst a consumer base there will be varying levels of resilience. However, given that there is a high likelihood a consumer could be adversely affected, firms will need to set their tolerance level at the lowest level. Having an understanding of vulnerability is key to setting an impact tolerance and firms should ensure they have considered the needs of vulnerable customers.

This has been made more evident than ever through the publication of the FCA’s final guidance on this subject<sup>14</sup>, outlining their expectations for firms to embed the fair treatment of vulnerable consumers into a firm’s culture, but also in their policies and processes throughout the whole customer journey. Evidently, firms will need to consider a variety of factors to determine an intolerable harm threshold.

<sup>13</sup> ORCG ‘Impact Tolerances Industry Standard’, October 2020. This diagram is a product of its time (2020), and will remain under review by the ORCG as understanding matures through implementation. It should be noted that the publication of the PS indicates that the FCA are concerned with preventing intolerable harm specifically to consumers as well as disruption which could pose a risk to the orderly operation of financial markets.

<sup>14</sup> FCA, [Finalised Guidance FG21/1 Guidance for firms on the fair treatment of vulnerable customers](#), (February 2021).

When considering the impact of disruption on consumers, and risk to firms and the market, firms could consider the following:

- Model disruption to understand how service key performance indicators (KPIs) change when faced with a severe but plausible scenario.
- Analyse how the impact of this disruption changes over time.
- Assess the time required to bring the service back to normal, also considering additional knock-on impacts across the business.
- Look to capture proxy measures for harm, or conduct primary research to better understand the potential harm to clients.
- Examine contractual obligations where harm would arise out of a failure to meet that agreement. Although, where firms routinely deliver a service more efficiently than outlined in their contract, it can be difficult to place a harm threshold to capture higher customer expectations.
- The next stage could be to look at creating a quantitative harm index.

The FCA lists several areas where it seeks to mitigate harm in its cost benefit analysis in CP19/32, which can help firms gain a clearer idea of the types of harm the FCA is concerned with and thus provide a focus on what preventative measures firms can consider. These include:

- Seeking to improve the resilience of wider financial system and the economy;
- Better consumer and firm confidence and participation in financial markets;
- Reduced financial harm to firms and their customers;
- Reduced psychological stress to consumers; and
- Ensure consumers and firms have continued access to financial services.

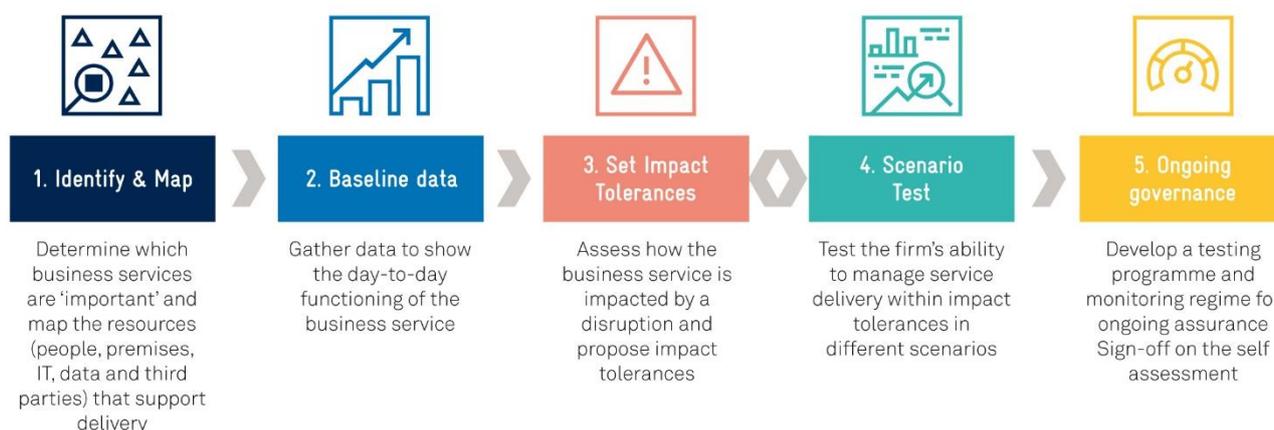
The FCA recognises impacts to consumers can go beyond ‘financial harm’ to include ‘psychological stress’, lack of ‘confidence’ and concerns over trust and ‘access’ to financial services. Firms can also refer to the [Financial Ombudsman Service’s website](#) where it sets out its guidelines to recompensing customers unfairly treated by firms and offers examples of awards for distress and inconvenience which give real life examples of moderate, substantial, severe and extreme impacts.

The Working Group discussed how to assess the impact of disruption on consumers and the different points at which these might translate into inconvenience, harm or intolerable harm. It was highlighted that ‘intolerable harm’ might cover a situation where the firm was unable to put the consumer in the position they would have been in if the incident had not occurred. Some examples are included in the table below, which consider the potential harms at a generic level. However, it is important to bear in mind that harms will vary by important business service.

<p><b>Intolerable harm</b></p> <p>Consumer is seeking litigation                      Firms may be unable to put their consumer back into the correct financial position                      Consumer has suffered a consequential loss or financial impact                      An impact causing significant distress to the end-investor</p>
<p><b>Harm</b></p> <p>Consumer is disadvantaged and dissatisfied                      Adverse financial situation has been put right by the firm                      Protracted disruption that has been resolved</p>
<p><b>Inconvenience</b></p> <p>No adverse financial impact                      Short term effect                      Consumer issue has been rectified, but is still unhappy</p>

## 2b Brief overview of the proposed approach

We have set out below a series of steps firms can consider when looking at setting their impact tolerances for their important business services. These steps do not form a set order and firms should adapt them accordingly to best suit their business model. When step 3 is reached, there are a series of sub-steps firms may wish to consider, which we develop in more detail in Section 2c. These sub-steps include being able to quantify disruption, agree what might be an intolerable impact, describing the impact for set timeframes, determining the time threshold and then calibrating the impact tolerance threshold reached amongst the firm’s important business services. Throughout this process, firms need to have their self-assessment document at the back of their mind and be able to outline the methodology undertaken.



This model for setting impact tolerances can be adapted in various ways, for instance a firm may wish to take a more judgement-led or data-led approach, dependent on the important business service in question. In some instances, there may be a wealth of data by which to assess and set impact tolerances but sometimes firms may need to rely on their judgement or empirical evidence to determine the point of intolerable harm. However, when taking a judgement-led approach, firms should be aware of relying on pre-determined assumptions from prior experience. In some cases, determining an impact tolerance threshold will be a blend of data and judgement, though one approach may take precedence. The Working Group recognised there are benefits to combining the approaches using a central programme team or function to complete data analysis to feed into work to develop impact tolerances, and complementing this with the experience and judgement of the business service owners and their teams.

## 2c Steps to setting impact tolerances



### 1. Identify your important business services and map the underlying processes

The regulators require enhanced firms to identify their most important business services and set an impact tolerance for each important service. The IA’s Important Business Services Working Group concluded last year with a report<sup>15</sup> on how firms might go about identifying what these are, and outlined six important business services firms could consider adopting, once adapted to suit their specific firm model and consumer base.

Firms will then need to identify and document the underlying processes which support the delivery of each of their important business services, including the people, processes, technology, facilities and information (resources). During this mapping stage, it is useful to consider the types of disruption which could impact the delivery of an important business service.

<sup>15</sup> IA *Important Business Services - Member Guidance*, June 2020

**Potential areas of challenge: Granularity**

The setting of an impact tolerance starts with being confident of the definition of your business services. There were wide ranging debates on the appropriate level of granularity by which to identify a firm's important business services in the Working Group. There is a balance to be struck with defining important business services at an appropriate level to prevent a proliferation of services that can make it difficult to get traction with the board with not having the appropriate amount of detail by which to capture the different variations when setting an impact tolerance. Firms should follow an approach that best suits their business model and consumer base.

**2. Gather baseline data**

Once a firm has agreed their important business services with their board, they can look at utilising existing data to establish a baseline for the day-to-day functioning of the service. By doing so, firms can understand how delays to the normal delivery of the service can manifest in harm. However, firms should also consider seasonal variations and other factors when conducting this exercise.

To understand what a service looks like on a 'normal' basis, firms will need to establish the appropriate data points to capture to measure this service. Some considerations include identifying the:

- Number of transactions during low and peak periods to help identify pinch-points
- Capacity to process transactions per hour
- Average value of transactions
- Average number of customer calls per day
- Impact of planned new product ranges on existing volumes
- Current service level agreements in place

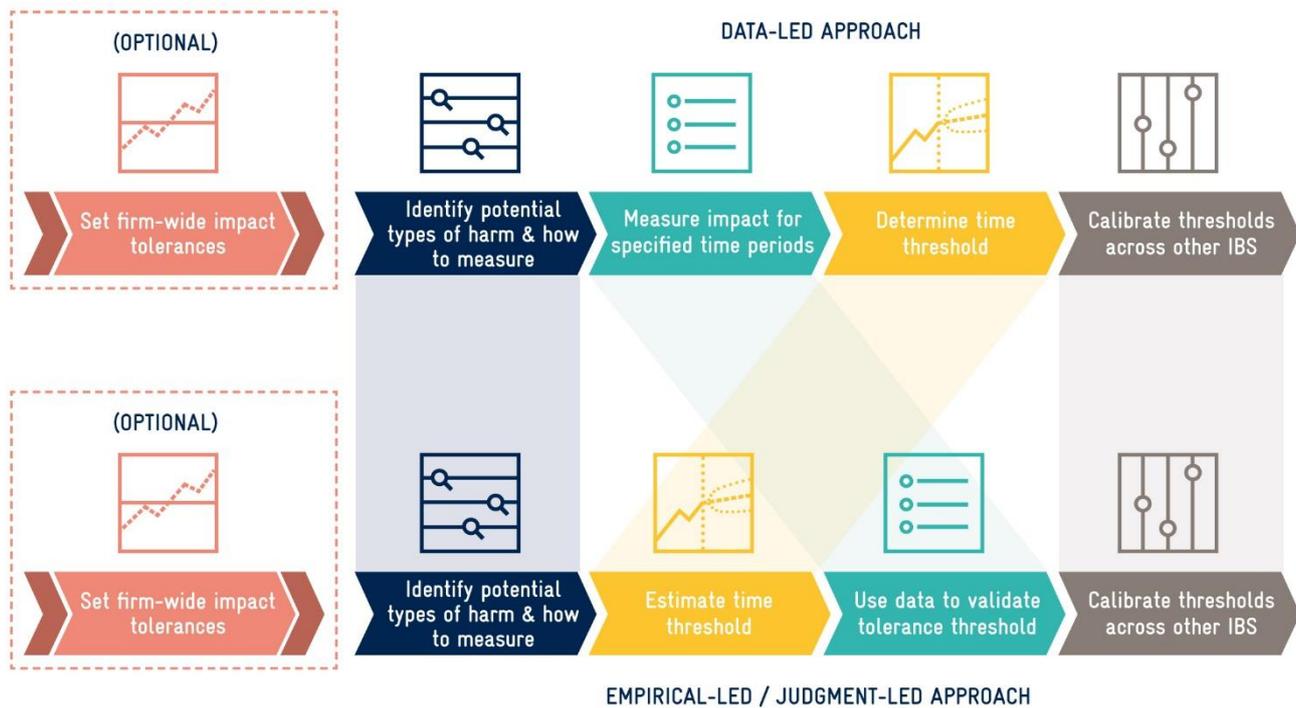
**Potential areas of challenge: availability of data**

A lack of data can be an issue when firms are looking to identify different points of harm and quantify disruption. However, in some instances proxy data can be used; for instance, to assess the impact of disruption to paying money out, firms may want to try to determine what consumers need their money for by looking at the size of withdrawal/proportion of withdrawal against existing assets.

Alternatively, firms may find they have a proliferation of data in some areas which can increase the difficulties with identifying the relevant data points. In these instances, it may suit firms to follow a judgement-led approach to setting impact tolerances.

**3. Set impact tolerance**

When going about the process of setting an impact tolerance for each of a firm's important business services, there are sub-steps which can be considered. For the most part, these do not need to be followed in any particular order and should be adapted according to firm preference. Firms will need to be able to evidence and justify how they have come to their impact tolerance conclusions.



**Data-led approach**

Depending on the extent of available data, firms may wish to take a data-led approach to setting impact tolerances. The Working Group noted that it can be challenging to assess which data points are relevant for setting impact tolerances and in turn being able to derive a single time threshold result. However, where data is available, it can form a useful basis by which to determine the point in time in which intolerable harm manifests to consumers. Firms may be able to establish the relevant data points from mapping their important business services and understanding the metrics that describe the resources needed to deliver the service. Other considerations for taking a data-led approach are laid out below.

a) (Optional) Set firm-wide impact tolerances

While this is not mandated by the policy statement, firms may choose to utilise an existing organisational impact matrix to assess the impact and severity of harm arising from a particular scenario, considering the impact on consumers, markets and the firms themselves. From the matrix, firms can look to agree where the descriptions of the impact to consumers, firms and markets cross over from inconvenience, to harm and to intolerable harm. This can help to bring a firmwide approach to defining intolerable impact before then considering the specifics for each important business service. The threshold for intolerable harm will likely vary by consumer and firm type.

The FCA requires firms to consider **ten factors** when setting impact tolerances:

1. Nature of the **client base**, including a consideration of vulnerability
2. **Number of clients** that may be adversely impacted
3. Potential **financial loss to clients**
4. Potential **financial loss to the firm** where this could harm the firm's clients or pose a risk to the resilience of the UK financial system
5. Potential level of **reputational damage** to the firm where this could harm the firm's clients or pose a risk to the resilience of the UK financial system
6. Potential **impact on market or consumer confidence**
7. Risk of contagion to other business services, other firms or the UK financial system
8. Potential loss of functionality or access for clients
9. Potential loss of confidentiality, integrity or availability of data
10. Potential **aggregate impact of disruptions** to multiple important business services

Firms can also consider:

- Typical time frames where harm could occur
- Complaint levels and volume of client contact
- Estimated time to recovery

#### **Potential areas of challenge:** vulnerable consumers

Ensuring the needs of vulnerable consumers are met can be a challenge, as can understanding how this interacts with setting impact tolerances. The FCA clarified in their policy statement that separate impact tolerances are not needed for vulnerable consumers as these should already be considered through the process of identifying important business services and setting impact tolerances overall.

#### b) Identify potential types of harm and how to measure them

Identify the metrics involved to measure the threshold at which intolerable harm is reached. This will likely vary depending on which important business service a tolerance is being set for. The policy statement outlines ten different factors to consider when determining harm to the consumer or market integrity, which forms a useful baseline. Firms should reflect on the analysis they completed to determine their important business services as there is a logical overlap. Building on the FCA's factors, we have included additional considerations below.

#### c) Measure impact for specified time periods

Given the regulatory requirement to set an impact tolerance including a duration metric, firms will need to look at how quickly intolerable harm will manifest. As such, it is useful to agree what time periods can be used to assess the impact of disruption. These time periods should be relevant to the important business service identified.

**Duration metric:** When setting an impact tolerance, the FCA expects a firm to take account of the fluctuations in demand for its important business service at different times of the day and throughout the year in order to ensure that its impact tolerance reflects these fluctuations and is appropriate in light of the peak demand for the important business service. (SYSC 15A.2.8 G).

**Potential areas of challenge: establishing metrics**

It is likely that firms will need to utilise or include supplementary metrics to duration when setting their impact tolerances. In some instances, it may be easier to determine the impact on consumers rather than the intolerable duration of disruption, but in others, the converse may be true.

It can be challenging to work out which data points are relevant for setting impact tolerances and using them to derive a single impact tolerance. Establishing the worst-case scenario as a baseline can be helpful to ensure an impact tolerance is not set at too low a level.

d) Determine time threshold

There will be a point where the impact from a severe but plausible scenario will trigger intolerable harm which will vary across firms. Firms will then need to determine the most relevant metric to support duration to optimise the setting of a tolerance level. A combination of metrics may sometimes be more appropriate; many in the Working Group agreed duration will often be a useful metric for setting impact tolerances, but that it is not the only useful metric and measuring the impact of disruption, value and volume are also useful considerations. For instance, if the maximum tolerable duration for a disruption to a particular important business service was 5 days, a firm may also want to assess the maximum number of customers impacted in that period.

e) Calibrate thresholds across other important business services

Once an impact tolerance has been set, it is worth assessing this against the tolerances set for a firm's other important business services to ensure a consistent approach had been applied with comparable magnitude.

**Judgement-led approach**

The methodology above provides a structured way of extrapolating a tolerance threshold based on analysis of data and will suit some firms and important business services. However, the FCA does not prescribe any specific approach to setting impact tolerances – as part of the self-assessment they expect to see the firm's impact tolerances and the justification for the levels at which they have been set, as well as the methodology to determine them. The Working Group recognised that in some instances it may be preferable to set impact tolerance thresholds based on the experience of the teams involved, and then to validate these thresholds using available evidence. We have described this as a 'judgement-led approach'. There is no single right way to determine impact tolerance thresholds, so firms need to work out the most appropriate approach and ensure that sufficient rigour has gone into the decision.

**Potential areas of challenge: justifying an impact tolerance threshold**

Firms will need to evidence to their boards and the regulators that they have set and are able to remain within their impact tolerances as well as justify the level at which these tolerances have been set. However, it remains a challenge to determine the justifications for why a firm has chosen that impact tolerance. Assessing the appropriate justifications is largely grounded in deciding which metrics to use to set an impact tolerance and then either taking a data-led or judgment-based approach in interpreting the metrics.

Firms will also need to be aware that they are expected to take into account the impact of failure of other related important business services when setting impact tolerances for an individual important business service.



#### 4. Scenario test

Firms should test their ability to remain within their impact tolerances for each of their important business services and understand how certain events may mean they cannot remain within their tolerance thresholds. Where firms are unable to remain within their tolerances, firms should take remediating action where necessary. Firms will need to be prepared for a range of ‘severe but plausible’ scenarios and the IA will be addressing this aspect in more detail with its Scenario Testing Working Group.

The FCA indicates that scenario testing is a planning tool to ensure services can remain within impact tolerances: *“In carrying out the scenario testing, firms should identify an appropriate range of adverse circumstances varying in nature, severity and duration relevant to its business and risk profile. They should then consider the risks to delivery of the firm’s important business services in those circumstances.”*<sup>16</sup>



#### 5. Ongoing governance

To ensure effective operational resilience, it needs to be built in holistically to a firm’s risk management and business continuity processes. The board and senior management have a key role to play in directing, evaluating and monitoring this operational resilience framework. Firms will need to give due consideration to how they wish to structure their governance arrangements as well as their reporting lines. For instance, firms may wish to consider if their broader operational resilience strategy should be a second line risk-led initiative or led by IT and technology teams.

Firms should develop a testing programme and monitoring regime to provide ongoing assurance of their impact tolerances. Moreover, firms will need to be able to evidence that they are meeting their operational resilience responsibilities to the regulator via the self-assessment document. This self-assessment document will need to be reviewed and approved by the board regularly, for instance where changes occur which have a material impact on the firm’s operational resilience.

For more information on governance arrangements, we encourage firms to refer to the IA’s report on the *Effective Governance of Operational Resilience* produced with EY.<sup>17</sup>

## 2d Challenges

From the Working Group discussions, it was evident many were facing similar challenges as the Group worked through different methodologies by which to set impact tolerances.

### Third party suppliers

Aligning a firm’s impact tolerances to the standards of resilience offered by its third parties was raised as a challenge members were grappling with, particularly as many use third party suppliers as part of their end-to-end service provision. There were concerns that if there was a disconnect between the tolerances set by the firm and the resilience standards of its supplier, it may affect the desired resiliency outcome. The regulators have made it clear that firms retain full responsibility for ensuring they set, and can remain within, their impact tolerances regardless of their outsourcing arrangements.

To address this, firms should engage with their suppliers to ensure they have looked to mitigate any of these risks and document their process taken. It may be necessary to examine existing service level

<sup>16</sup> CP19/32 *Building Operational Resilience*, 6.8, p22

<sup>17</sup> IA/EY *Effective Governance of Operational Resilience*, February 2021

agreements (SLAs) and renegotiate some aspects. The buy-in from the board may be a key factor in this respect, because if the SLA is unable to be aligned to their requirements, the next step may be to look to alternative suppliers. However, there may also be technology solutions or other processes that could be introduced if firms are concerned that their reliance on a service provider may result in a breach of their impact tolerance.

## Integrating operational resilience into existing risk management processes

Given that the concept of ‘impact tolerances’ is relatively new, it can be difficult to establish how the process for setting these might integrate into a firm’s existing risk management framework. There is no silver bullet solution for firms in this area, and we welcome the regulator’s proportionate approach to allow firms to determine the best method for their particular business model and client type. In some cases, firms may wish to create a resiliency team from scratch, bringing together risk, business continuity and technology personnel. In others, it may make more sense to align a firm’s impact tolerances setting process with their risk framework or align it with their ICAAP/ICARA<sup>18</sup> process.

## 2e Impact tolerance statement

In their policy statement, the FCA outlined examples describing how a firm might set and remain within their impact tolerances. Impact tolerance statements are a useful way of articulating clearly and concisely to boards and the regulators how firms have reached their impact tolerance conclusions. A key element of all statements will be a need to indicate a certain period, or point in time, a particular important business service should not be disrupted beyond. The FCA indicated in their policy statement that this could be a number of hours/days or a point in time, such as the end of the day in conjunction with a certain level of customer complaints or volume of interrupted transactions. However, firms may wish to supplement this with other metrics. Using a combination of metrics may be more appropriate for some important business services, for instance where a service could run at a percentage capacity of its full capability for a certain period (time) before causing intolerable harm to consumers or risk to market integrity. Using the example of our fictional firm (OR Investment Management) from our Important Business Service paper, we have explored how firms might approach writing impact tolerance statements based on the format of the examples provided in the policy statement.

### Sub-tolerances

In the example below, we have offered an additional sub-tolerance consideration, which is intended to be complementary to the overall impact tolerance. This is optional and by no means necessary, as solo-regulated firms are only required to set one impact tolerance per important business service, but in certain cases firms may find it helpful to include sub-tolerances for their internal workings. For instance, as in the example, if a firm with both a retail and an institutional consumer base was concerned that the tolerance levels would differ dependent on the consumer type impacted, this may be a way to denote separate implications.

### Non-duration metrics

The example also includes the non-duration metrics of volume and value of payments. This provides additional colour to the impact that disruption could have on consumers in different ways. We did not specify the numbers or amounts in our example but clearly a firm’s impact tolerance statement would contain this detail.

<sup>18</sup> Internal Capital and Risk Assessment process (ICARA) replaces ICAAP in January 2022.

**Important business service:** Cash payments out of UK funds

**Impact tolerance statement:** OR Investment Management (ORIM) will not tolerate cash payments out of its UK funds to be delayed by more than three days.

**Supporting rationale:**

- ORIM manages a range of daily-dealing UK funds covering a variety of public market asset classes and strategies. Its funds are held by retail and institutional clients.
- This important business service covers the actual transfer of money from the fund to the client and includes redemptions, income payments and regular payments. In evaluating this important business service, ORIM assumed that the cash is ready for disbursement. ORIM's systems are the same for making payments both to retail and institutional clients. ORIM considered its dependency on its Transfer Agency (TA) in the provision of payments out and considered whether, if there was disruption to its TA, it could cause harm to consumers and risk to market integrity as well as affect other processes and services. ORIM assessed the potential harm to its clients and the risks to the firm and the wider market if it was unable to make distribution or redemption payments out of these funds. Under all scenarios, ORIM estimated that intolerable harm to its clients would occur before a risk was posed to the firm or to the wider market.
- ORIM considered the most immediate harm would be to its retail clients as a result of not receiving their cash payments in the expected timeframe; retail clients may have onward financial commitments, and while institutional clients could have liquidity requirements for their own products, the analysis suggested these clients would be better able to manage a delay to payments.
- In determining the harm to clients, ORIM considered any vulnerable customer groups that it either distributed its funds to directly, or that held its funds through an intermediary. There is no systematic way to identify the intended use of the payment by retail customers, which can range from high value legal commitments (e.g. house purchase), to essential spending (e.g. paying bills), to leisure spending. ORIM conducted analysis of its direct retail clients to identify the proportion that might be considered vulnerable, using FCA vulnerability characteristics (e.g. clients who rely on regular payments from the fund to meet essential spending). ORIM is able to identify payments to these customers when they are queued for processing and agreed procedures to prioritise these transactions during any operational disruption.
- ORIM considered how the delay to payments might affect clients if it occurred on a day of particularly high payment volumes and value; under these scenarios its analysis showed that intolerable harm was likely to occur to its retail clients if the payments were delayed for more than three days (72 hours), and to its institutional clients if payment was delayed for more than five days (120 hours). On this basis, taking the lowest common denominator, ORIM chose to determine the overall tolerance for disruption to this service at three days, and set an additional sub-tolerance for disruption to this service for institutional clients at five days.
- While improvements to the shared resources would benefit both retail and institutional clients, ORIM agreed that in a disruptive event it would seek to prioritise paying retail clients over institutional clients.
- ORIM also set additional metrics, covering the volume and value of payments for both of its client groups, e.g. ORIM would not tolerate more than a certain number or value of payments to be delayed to retail clients, or a certain number or value of payments to be delayed to institutional clients.

A tolerance statement such as this can be included in a self-assessment document, offering a clear and simple explanation of what the impact tolerance is for each of a firm's important business services and how a firm has come to this decision. Firms can also use these statements to ensure their thresholds for intolerable harm are calibrated across their portfolio of important business services. However, it is important firms adapt these to suit how they have defined their important business services.

## 2f Self-assessment document and ongoing updates

Firms' governing bodies will need to review and approve their important business services, the underlying resources required to support the delivery of the important business services and impact tolerance thresholds regularly and ensure the self-assessment document is kept up to date. Firms must also develop a scenario testing plan to ensure they can remain within their impact tolerances for each important business and carry out this scenario testing together with a lessons learned exercise.

### Self-assessment document

Firms are required to document the steps they are taking to remain in compliance with their resiliency obligations. This includes recording a clear explanation for the methodologies taken for the below activities:

- A list of the **important business services** identified and the justifications for how these have been determined.
- The **impact tolerances** for each important business service and the justification for the level at which they have been set.
- The firm's approach to **mapping** its underlying people, processes, technology, facilities and information necessary to the delivery of each important business service as well as how mapping has been used to help identify vulnerabilities and support scenario testing.
- The firm's **testing** plan including justification for the plan adopted as well as details as of the scenario testing carried out.
- Details of any **lessons learned** exercises.
- The **vulnerabilities** identified which may threaten the firm's ability to deliver its important business services within the impact tolerances set as well as the remediating action planned or taken to address these.
- The **communication strategy** and an explanation of how it will enable the firm to reduce the anticipated harm caused by operational disruptions.

This document should be approved by the board, regularly reviewed and be available to the FCA on request. The earliest date the regulator may request the self-assessment document is 31<sup>st</sup> March 2022, when the rules come into effect.

# PART 3 NEXT STEPS

## Next steps and conclusion

Firms will need to take action to ensure they can remain within their impact tolerances. Firms will need to be able to evidence that they can remain within their impact tolerances ‘as soon as reasonably practicable’ but no later than by 31 March 2025. The FCA also expects firms in scope to be able to evidence the resiliency actions that they are taking within the transitional period in their self-assessment document.

### *March 2021-2022: Implementation period*

- During this first year, before the rules come into effect, firms will be expected to implement all aspects of the policy, except being able to stay within their impact tolerances at all times.
- Firms will need to have carried out mapping and testing expectations by 31 March 2022 to a level of sophistication necessary to identify important business services, set impact tolerances and identify any vulnerabilities in their operational resilience.

### *March 2022-2025: Transitional period*

- During this three year period after the rules come into effect, firms will be required to invest in their ability to remain within their impact tolerances.

## Questions to consider

Setting impact tolerances requires a different approach to traditional approaches to risk management and business continuity practices. Understanding a firm’s tolerance for disruption is key to building operational resilience as it allows firms to put in place measures to ensure they stay within their impact tolerances and prevent harm to consumers and risks to the orderly function of the financial markets. This report has outlined a series of steps which firms can consider when setting their impact tolerances as well as ways to look at and define ‘intolerable harm’ to consumers. In addition, it has explored common areas of challenge identified by our Working Group and ways to address these. To conclude, we would like to leave firms with some questions they may wish to consider and that may help to prompt the conversation with the relevant teams to go about setting impact tolerances.

1. What is the maximum level of tolerable disruption? What constitutes intolerable harm?
2. Have you considered harm to consumer and the risks posed to the firm (and market)?
3. Have you considered at least these factors when setting impact tolerances?
  - nature of client base
  - number of clients that may be adversely impacted
  - potential financial loss to client
  - potential financial loss to firm
  - potential reputational damage to firm
  - potential impact on market or consumer confidence
  - contagion to other services or the UK financial system
  - loss of functionality or access for clients
  - any potential loss of confidentiality, integrity or availability of data
  - impact on other important business services
4. How can using tools from your existing risk management framework accelerate your progress and ensure an aligned approach?
5. Have you documented the methodology taken to assess and set impact tolerances?

# APPENDIX 1

## Amendments to SYSC

In the amendments to the Senior Management Arrangements, Systems and Controls sourcebook (SYSC), with effect from 31 March 2022 (subject to transitional arrangements), the FCA require enhanced scope SM&CR firms to:

15A.2.5 R Set an impact tolerance for each of its important business services

15A.2.6 R Keep its compliance with SYSC 15A.2.5R under review and, in particular, consider its compliance in the following circumstances:

- if there is a relevant change to the firm's business or the market in which it operates; and
- in any event, no later than 1 year after it last carried out the relevant assessment.

15A.2.7 G Consider 10 factors when setting its impact tolerance which include, but are not limited to:

- (1) the nature of the client base, including any vulnerabilities that would make the person more susceptible to harm from a disruption;
- (2) the number of clients that may be adversely impacted and the nature of impact;
- (3) the potential financial loss to clients;
- (4) the potential financial loss to the firm where this could harm the firm's clients or pose a risk to the soundness, stability or resilience of the UK financial system or the orderly operation of the financial markets;
- (5) the potential level of reputational damage to the firm where this could harm the firm's clients or pose a risk to the soundness, stability or resilience of the UK financial system or the orderly operation of the financial markets;
- (6) the potential impact on market or consumer confidence;
- (7) the potential spread of risks to their other business services, other firms or the UK financial system;
- (8) the potential loss of functionality or access for clients;
- (9) any potential loss of confidentiality, integrity or availability of data; and
- (10) the potential aggregate impact of disruptions to multiple important business services, in particular where such services rely on common operational resources as identified by the firm's mapping exercise.

15A.2.8 G When setting its impact tolerance, the FCA expects a firm to take account of the fluctuations in demand for its important business service at different times of the day and throughout the year in order to ensure that its impact tolerance reflects these fluctuations and is appropriate in light of the peak demand for the important business service.

15A.2.9 R A firm must ensure it can remain within its impact tolerance for each important business service in the event of a severe but plausible disruption to its operations.

15A.2.10 G While under SYSC 15A.2.9R a firm must ensure it is able to remain within its impact tolerance, it should generally not do so if this would put the firm in breach of another regulatory obligation, conflict with the proper exercise of a discretion granted to it under any rule or regulation, or result in increased risk of harm to its clients or the soundness, stability or resilience of the UK financial system or the orderly operation of the financial markets. Under certain circumstances, a firm may wish to resume a degraded service. This is usually only appropriate if having regard to the interest of the firm's clients, the soundness, stability and resilience of the UK financial system and the orderly operation of the financial markets, the benefits of resuming a degraded service outweigh the negatives of keeping the service unavailable until the issues have been fully remediated and the service is able to be fully restored to its pre-disruption levels.

15A.2.11 G Under Principle 11, the FCA expects to be notified of any failure by a firm to meet an impact tolerance.



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